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A review by the Federal Reserve Bank of Chicago

Business Conditions

1952 November



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Home building holding up

Housing starts have been higher than in 1951, but the ending of credit controls won't provide much additional stimulus.

As 1952 NEARS ITS CLOSE, it is apparent that home builders have been enjoying their sixth consecutive year of high activity. Private housing starts in the nation have run consistently ahead of 1951 since early spring, with construction getting under way on 819,000 units during the first nine months. By the end of 1952, total private starts are likely to surpass last year's 1,020,000, the largest number on record except during the tremendous boom of 1950.

Statistics on over-all building activity, however, do not tell the whole story. Although the demand for new homes has continued relatively strong, prospective buyers are more selective than at any time in the past decade. Earlier this year some builders accumulated inventories of unsold new houses, although most of these now appear to have been moved without substantial price concessions. Greater buyer resistance forced many builders to partially absorb the small increase in construction costs which took place, however, and this experience has introduced a note of caution into future building plans.

A shortage of mortgage money has been a problem in many communities, but the ending of Government controls over mortgage credit terms in September should ease this problem somewhat. It will allow down payment requirements to be lowered in the case of preferred risks and will permit secondary financing and sales on land contract to be employed where houses are moving slowly. Whether most lenders, however, will be willing to ease terms on conventional loans significantly at this time remains to be seen. Down payment requirements for FHA and VA mortgage loans have been liberalized, but the supply of money

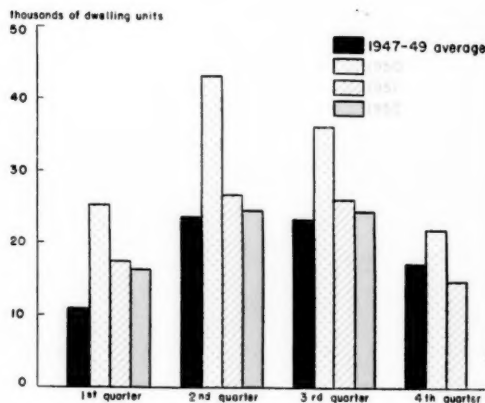
seeking such investment outlets continues restricted in amount.

District home building steady

Residential construction activity in the Seventh District states has continued steady this year at a level close to the 1951 rate. Although the number of urban dwelling units authorized during the first three quarters has been far below that of the same period in 1950, building permit volume compares favorably with that of earlier postwar years (see chart).

The District totals, however, conceal important variations in activity among the major metropolitan areas. Residential building is continuing at or above the average postwar rates in the Chicago area and in Milwaukee, but is off sharply in the Detroit area and in Indianapolis. One factor contributing to the

Residential building in urban areas of District states continues high, but well below 1950



maintenance of activity in Chicago and Milwaukee is that the level of building in earlier postwar years had been low relative to population. In addition, mortgage money has continued in better supply in these two cities.

The Chicago area bulks large in total District home building. In 1951, it accounted for nearly 40 per cent of all urban dwelling units authorized in the five District states. Moreover, almost 90 per cent of the building permits issued in the first half of 1952 were for one and two family homes, many of which were constructed for sale upon completion.

Building activity has been very good here as is indicated by the number of dwelling units for which building permits were issued in the first three quarters of 1952, compared with earlier years.

	First half	Third quarter
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1949.....	12,900	7,400
1950.....	22,500	13,100
1951.....	16,800	9,500
1952.....	17,300	9,500

Builders have been confronted with increased buyer resistance in this area as elsewhere in the District, but at no time this summer has the inventory of completed unsold homes been a general problem. Furthermore, any inventory accumulation which had taken place earlier this year has been about worked off during the past two months. Conventional mortgage money has been in ample supply in the Chicago area, but FHA loans are tighter and VA money virtually unobtainable except by large project builders.

The Detroit area, on the other hand, has experienced a lower volume of housing starts in the first three quarters of 1952 than in any other postwar year. To some extent this decline in home-building activity reflects a relatively greater satisfaction of housing demand stemming from the larger building programs of earlier years. As seen in the following table, which includes only one and two family

houses, the number of building permits issued reached a very high level in the boom year of 1950.

	First half	Third quarter
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1949.....	8,300	7,300
1950.....	15,200	5,500
1951.....	7,800	3,200
1952.....	5,300	3,000

The sales difficulties of builders in the Detroit area appear to have been more acute than those generally faced throughout the District. Inventories of completed homes were a fairly serious problem early in the summer and some builders were able to move higher priced homes only by means of price concessions. Finally, the supply of mortgage money has been considerably tighter than in Chicago for both conventional and Government insured and guaranteed loans.

In Milwaukee home-building activity has held up well. A larger number of permits was issued in the first nine months of this year than in the corresponding period of any postwar year prior to 1950. Moreover, the table below shows that the number of dwelling units placed under permit through the third quarter of this year is running only 9 per cent below 1951.

	First half	Third quarter
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1949.....	1,100	1,400
1950.....	3,200	2,000
1951.....	1,800	1,300
1952.....	1,700	1,200

Since most of the home building in Milwaukee is done by comparatively small contract builders, accumulation of unsold completed units has not been a problem. However, some slackening in the eagerness of prospective home buyers has been in evidence. The supply of funds available for conventional and FHA mortgages is as ample here as anywhere in the District. In addition, there is a fairly sizable market for VA loans, although at down pay-

ments considerably greater than the minimum required by law.

In *Indianapolis*, housing activity picked up sharply this year with the number of building permits issued running well ahead of year-ago figures. Activity in both 1951 and 1952, however, has been lower than in earlier years.

	First half	Third quarter
1949.....	1,700	700
1950.....	2,000	1,100
1951.....	600	500
1952.....	900	700

No appreciable inventory of unsold homes developed in *Indianapolis*, since here as in *Milwaukee* the large majority of homes are built on contract. Nevertheless, serious sales problems have been faced by builders in this area. Probably the greatest deterrent to housing demand is the extreme tightness of mortgage money. Also, a relatively small amount of suburban development in this area has resulted in a scarcity of improved lots for a number of builders. Recent annexation to the city of land on which 700 homes are to be built may point to an easing in this problem.

Money troubles

During the past 18 months, the relative scarcity of mortgage funds has probably been as important as restrictions on credit terms in holding down the volume of home building. Many banks and insurance companies have sharply reduced their mortgage lending activity. Reasons for this partial withdrawal from the mortgage market are clear. Heavy capital expenditures by business have resulted in a record volume of corporate security offerings and a strong demand for working capital loans. Many lenders had been channelling an unusually large proportion of their funds into mortgages and welcomed this opportunity to acquire larger amounts of corporate debt and achieve a better balance in their investment portfolios. At the same time a general and

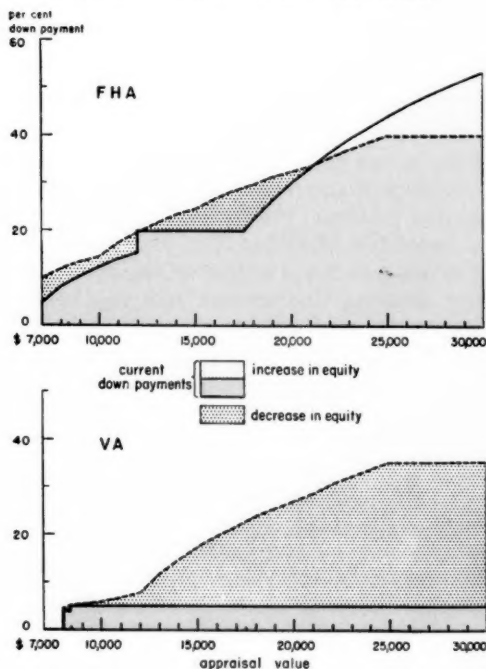
sizable increase in interest rates took place, greatly reducing the attractiveness of investment in fixed rate VA and FHA loans.

The pattern of reduced lending activity on the part of institutional investors does not extend to the savings and loan associations, however. These institutions are restricted by law to investment in mortgages or Government securities. Since the spring of 1951, savings and loan associations have received by far the largest inflow of savings in their history. As a result, they have extended mortgage credit in record volume, but have concentrated their activity in conventional rather than Government insured or guaranteed loans.

The relaxation of Government controls over

—continued on page 15

Minimum down payments eased on most FHA loans . . . cut to nominal amounts on all VA loans



World Bank develops resources

Power and transportation loans dominate world-wide investment pattern.

THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT last month floated its fifth bond issue in the U. S. The 60 million dollar 19 year 3½ % World Bank bonds were marketed at 98, yielding approximately 3.65 per cent to investors. The issue was quickly sold at the offer price.

Previous issues have well established the marketability of World Bank bonds. Large institutional investors in the U.S. own most of the currently outstanding bonds; mutual savings banks, life insurance companies, and pension and trust funds each hold about 20 per cent of the total. Another 20 per cent is held by commercial banks and other investors. The remainder, including most of the foreign currency bonds, is owned outside the U. S.

Bank in review

The World Bank, organized with its sister institution, the International Monetary Fund, in 1945, has a long-term objective. It has assisted in financing the rebuilding of war devastated areas, but is now mainly concerned with the economic development of the more "backward" regions of the world. Emphasis is on the construction of basic economic facilities. Although each loan must be for a specific purpose, individual projects are considered in relation to their contribution to the over-all growth of a country. In most cases, the Bank loan finances the foreign exchange costs of individual projects or portions of developmental programs, with domestic capital contributing the local currency costs. Thus, both international and local resources are used on the typical project.

Thus far, the World Bank has made loan commitments for 1.4 billion dollars of which

U.S. has been the main market for World Bank bonds

Bonds payable in:	Million dollars
U.S. dollars	\$510.0
Pound sterling	14.0
Swiss francs	22.2
Canadian dollars	13.6
Total bonds outstanding, November 30, 1952	\$559.9

Note: Components do not add up to total because of rounding.

300 million were made in the last fiscal year. By way of comparison, only four commercial banks in the U. S. have loans outstanding in excess of those of the World Bank.

The Bank, in addition, can guarantee loans floated by the borrower in private capital markets. Almost 37 million of such obligations are presently outstanding. Unlike a commercial bank, the World Bank has no depositors that add to its resources. Aggregate commitments are limited to a one-to-one ratio to the Bank's subscribed capital and borrowed funds.

Limit on Bank's resources

When the Bank was set up at Bretton Woods, critics referred to the plans as "grandiose" in terms of the need. Now, however, many experts doubt that the Bank's resources are adequate for the task it has undertaken. Of the total funds presently available for loans—paid-in capital, funded debt, repayments, and operating income—only 235 million dollars remains uncommitted.

The Bank has granted loans totalling 300 million dollars in each of the last two fiscal years. In 1950, a special committee set up to study international economic policies suggested

World Bank resources available for lending are limited

Sources of funds	Million dollars
2% paid-in portion of subscription.....	\$165.5
18% portion made available by member countries	<u>663.4</u>
Total available capital subscription*.....	828.9
Operating surplus	59.0
Funds from bond sales.....	559.9
Funds from sale of loans and principal repayments	<u>66.7</u>
Gross total available funds.....	1,514.5
Loan commitments	<u>1,280.0</u>
Uncommitted funds, November 30, 1952....	\$234.5

*The remaining 80 per cent of the Bank's capital is a contingency reserve that can only be called to meet the Bank's obligations.

that an annual rate of lending of 600 to 800 million is urgently needed for basic developmental programs. Of this, the Bank was to supply 400 million.

The Bank cannot expect to significantly augment its supply of loanable funds from the sale of its loans or from its repayments in the next several years. To expand its loan program or even to continue the current rate, the Bank will have to increase its borrowings.

The Bank's ability to finance private industry in underdeveloped countries is limited by two restrictions in its charter. First, it cannot engage in equity financing. On occasion the Bank has had to abandon consideration of promising projects because the promoter could not supply the equity capital needed. In addition, the Bank's charter requires that all loans to private enterprises must be guaranteed by the government of the country in which the loan is made. Some businessmen have been reluctant to seek loans from the Bank for fear that the guarantee would lead to government interference in the conduct of their business. Also, foreign governments have at times hes-

itated to grant guarantees for fear of charges of favoritism to particular business interests.

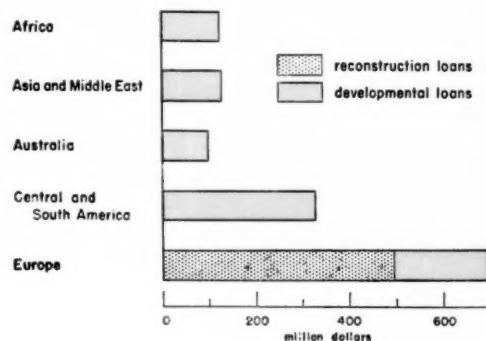
Private capital sought

To deal with the equity capital problem, the creation of an International Financial Corporation as a means of increasing both public and private investment in private ventures has been proposed. This Corporation would be authorized to make direct investment through the purchase of equities and to make loans to private firms without governmental guarantees.

Under the proposal, the capital would be subscribed by the member governments, not by the Bank. As an affiliate of the Bank, however, the Corporation would be free to make the fullest possible use of the Bank's technical and administrative staff. It would accept no responsibility for managing the enterprise in which the Corporation had invested, nor would it have any special immunities or privileges. The Corporation would try to revolve its funds as fast as possible by selling the "seasoned securities" in its portfolio.

A number of obstacles would have to be surmounted before such a Corporation could stimulate any sizable amount of private investment. For example, the barriers that now inhibit the free flow of private investment—namely the risk of nonconvertibility and ex-

Widely scattered areas have received developmental loans



propriation—would continue to apply. In order to compensate for the risks, the prospect of high capital yields would be needed to induce the cooperation of private investors. Unfortunately, the basic developmental projects are not necessarily the most profitable ones. The Corporation's ability to directly invest in new enterprises and to mobilize private foreign and local capital for such undertakings is therefore limited. Some experts doubt that it can successfully fulfill the purpose for which it was designed.

Developmental loans predominate

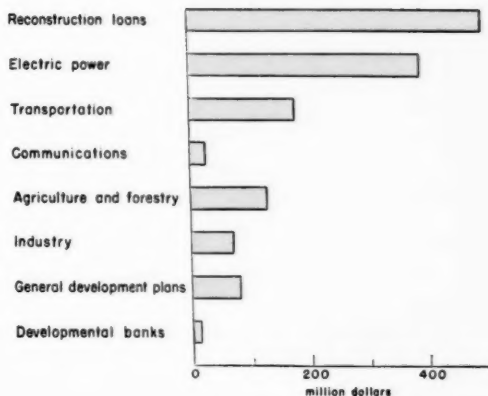
Before the Marshall Plan aid became available in the latter part of 1947, Bank operations centered on reconstruction loans, emergency accommodations to European countries in desperate need of industrial plant and equipment to replace that destroyed during the war. The World Bank's first four loans totalling 497 million dollars were granted in 1947 to France, Denmark, Luxembourg, and the Netherlands for this purpose.

In subsequent loans, the Bank has concentrated on projects in underdeveloped countries. It has sought to expand and improve basic facilities, a prerequisite to industrialization and better utilization of agricultural and mineral resources. Of the 885 million of developmental loans, over 44 per cent has been for electric power and 23 per cent has been devoted to increasing transportation and communication facilities. Manufacturing and mining equipment has accounted for 8 per cent of the developmental loans granted, while another 14 per cent has been used to raise agricultural production.

Raw materials for the U.S.

There is a growing awareness that the U. S. needs to develop additional sources of raw materials. The recent report of the President's Material Policy Commission has pointed out that current consumption rates of many basic commodities are rapidly outstripping our

Uses of World Bank loans



domestic production of these commodities and that this gap probably will continue to widen. An expansion of foreign sources of supply is indicated. While private investment is stressed as a major instrument for increasing the production of raw materials abroad, there also is need for public action. The Commission recommended that the International Bank continue to serve as the main source of public loan funds for basic economic developmental needs—power to operate mines and factories and transportation facilities to carry the materials to their markets. Without these expenditures, increased production and distribution of industrial goods and vital raw materials would be impossible.

Although the World Bank has been able to meet only a small part of the need for developmental capital, it has made strides toward raising production and living standards in the less developed areas of the world. The Bank has been an innovator and experimenter in the field of developmental loans. It has succeeded in adapting its loan operations to the changing world economic climate. If the World Bank continues to mold its policy to basic world economic needs, it will contribute to the maintenance of our own industrial strength.

THE

Trend

OF BUSINESS

THIS FALL an expanding American economy is demonstrating its ability to "live with" defense expenditures exceeding 50 billion dollars per year. Increases in capital outlays and deliveries of military goods in the past two years have been achieved with a much looser harness of controls than previously had been thought necessary.

Average wholesale and spot commodity prices are now well down from post-Korea peaks. Price controls have been cancelled or suspended for goods which account for one-fourth of all wholesale market transactions and many items still under control are selling below ceiling. Despite steel shortages, general inventory rebuilding, rising personal income, a continuing gradual rise in defense outlays, and a large second-half Federal deficit prices, appear to be levelling on a new plateau.

Good business is the rule in almost all lines. Textiles, leather, and paper and rubber products which had suffered varying degrees of depression have recovered and still appear to be in the midst of upward cycles. Business profits will doubtless show significant improvement in the fourth quarter of this year.

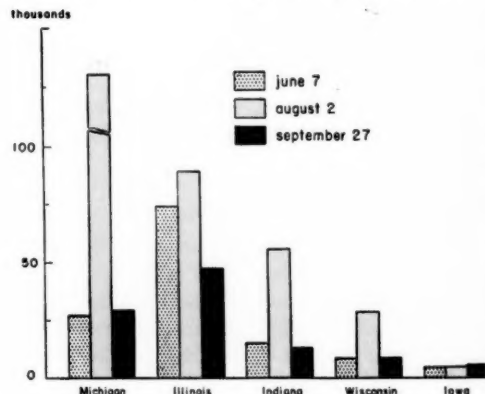
Unemployment in September is estimated to have been only 1.4 million for the nation. Larger manufacturing and service payrolls are being supplemented by a good level of farm income resulting from excellent crops and relatively stable prices.

General optimism concerning the business outlook through the winter is almost universal. For the longer term, however, reservations as to the durability of the upswing are common because of the levelling of defense outlays and expenditures for plant and equipment expected

in 1953. These warnings are serving to moderate the bullish sentiment which normally accompanies a period such as the present and thereby lessening the impact of a later readjustment.

National security outlays for goods and services in the six months ending October 1 totalled almost 25 billion dollars—up 25 per cent from a year earlier and almost three times the 1950 rate. Most of the increase in the past year has been traceable to rapidly rising deliveries of planes, tanks, and other heavy war goods. These deliveries will continue to bulk large for a long time to come. Of the 129 billion dollars appropriated by Congress for military procurement and construction since Korea, 58 billion is still in process and 30 billion has not yet been obligated.

Unemployment falls sharply after steel strike as shown by drop in number claiming compensation



Steel supplies are rapidly becoming adequate to meet current demand. Severe shortages are still reported for such items as heavy bars and plates, alloy steels, and nickel-bearing stainless, but holders of priorities are able to fulfill their needs in almost all cases.

In mid-October according to *Iron Age*, mills were "turning out finished steel so fast that there are not enough freight cars to haul it away." Full capacity operations are expected to continue into the second quarter of 1953, but later in the year some company officials expect below-ceiling operations. In the meantime, "conversion deals" and purchase of foreign steel are less common than in previous times of shortages. Users are shying away from the prospect of building high-cost inventories.

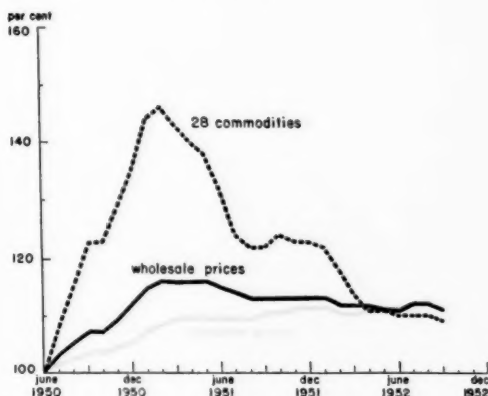
Over-all employment in District states this fall is at a new record high. This region suffered a greater decline in employment during July and August as a result of the steel strike than did other areas. In September, however, the situation was reversed. Since then almost all Midwest manufacturing centers have been experiencing tighter labor markets. New plants completed by the automobile industry in eastern Michigan to produce tanks and aircraft are being staffed only with difficulty.

Manufacturers whose workers took other jobs as a result of the steel strike are finding that replacements are unavailable in some cases. Retail and service establishments anticipate difficulties in obtaining sufficient extra help during the pre-Christmas season.

Construction contract awards for commercial, manufacturing, and utility projects in this area for the first nine months of 1952 were reported by F. W. Dodge to be almost 40 per cent below the same period for 1951. Some activity is being delayed, currently, by slow deliveries of structural steel.

Nationally, the goals for enlarged capacity set in connection with the defense program are being approached. Steel capacity at 113 million tons is 13 per cent above the total for

Price indexes level out



June 1950. Basic aluminum production facilities have been boosted by almost 50 per cent and electric power by 30 per cent.

Bank loans at Seventh District weekly reporting banks have been growing more slowly than in the nation generally. Business loans have risen less than expected at midyear, indicating some improvement in business liquidity.

New loans to metals and metal products firms, which were mainly responsible for the swift rise in industrial loans in 1951, have been much less important this year. Many of these concerns have begun to pay off outstanding loans now that inventories have been built up and deliveries of military goods started. New credits have dropped in recent weeks and continuing repayments have reduced outstandings.

Retail trade in the six months ending September 1 was about 5 per cent above 1951. Until recently department stores have not done so well, but in recent weeks they have enjoyed a brisk fall business. In the four weeks ending October 18, sales at District department stores exceeded the same period of 1951 by 4 per cent—physical volume was somewhat higher. Indications are that excellent Christmas business will be experienced in the remaining weeks of the year.

Who gets the interest?

Individuals receive the largest share of the Treasury debt charge.

POPULARLY, the Federal debt is considered only as a huge governmental liability. To many investors, however, it is also an important earning asset. Thus, the annual interest payment by the Treasury constitutes a sizable chunk of investment income for millions of individuals and institutions.

The Treasury expects interest costs for fiscal year 1953 to total 6.4 billion dollars. This makes the debt charge the second largest item in the Federal budget, outranked dollarwise only by the cost of the national security programs.

Not all of this 6.4 billion tab will actually be paid out in cash this year. About 1.6 billion consists of "noncash" accruals and transfers to various accounts and agencies within the Government itself. Nevertheless, the total amount represents a fixed obligation upon the Government; and, unlike other Federal expenditures which may be varied from year to year directly by Congressional action, interest cost is subject to change only as securities are issued, retired, or refunded under changing interest rates.

Who receives this interest money? Some groups in the economy have loaned more heavily than others, but there is hardly an investor class which does not receive interest payments from the Federal Government.

The biggest Federal interest "check" goes to individuals. Although they hold less of the debt than all businesses combined, they own a larger share than any single type of business. According to Treasury estimates, individuals held about one-fourth of the 260 billion dollars of interest-bearing debt outstanding in mid-1952. On the basis of these holdings, they stand to receive an estimated 28 per cent of the annual interest charge. Their share of the current debt charge is greater than their share

of the debt because their holdings are largely concentrated in savings bonds. These are primarily Series E bonds which pay a higher rate of return than any other type of Government security offered to the public.

Interest on E bonds is not, of course, paid out currently in cash; it simply accrues at an increasing rate until the bonds are redeemed. If all savings bonds currently outstanding are held until maturity, about 1.6 billion dollars of interest will accrue or be paid out annually to individuals on their present debt holdings. This amount is payable to an estimated 45 million people who hold Government securities—almost one-third of the population.

Banks take second place

As might be expected, the second largest share of interest income goes to commercial banks. With holdings of over 61 billion, or almost 24 per cent, of all Federal securities, the 14,000 banks in the country earn about one-fifth of the Government interest charge. Thus, although their debt holdings are almost as large as those of individuals, their share of total interest payments is considerably smaller. This reflects the fact that in mid-1952 approximately 40 per cent of commercial bank holdings were in relatively low rate, short-term securities—bills, certificates, and notes. As a result, the average interest rate on all Governments held by commercial banks was 2.01 per cent, as compared with 2.63 per cent for individuals' holdings.¹

Although they are still in the second spot

¹ Estimated average interest rates paid to Government security holders as of June 30, 1952 (in percent): Government trust funds, 2.66; individuals, 2.63; savings and loan associations, 2.59; life insurance companies, 2.51; mutual savings banks, 2.45; miscellaneous investors, 2.39; state and local governments, 2.34; fire, casualty, and marine insurance companies, 2.30; commercial banks, 2.01; Federal Reserve Banks, 1.91; nonfinancial corporations, 1.90; total outstanding Federal debt, 2.33.

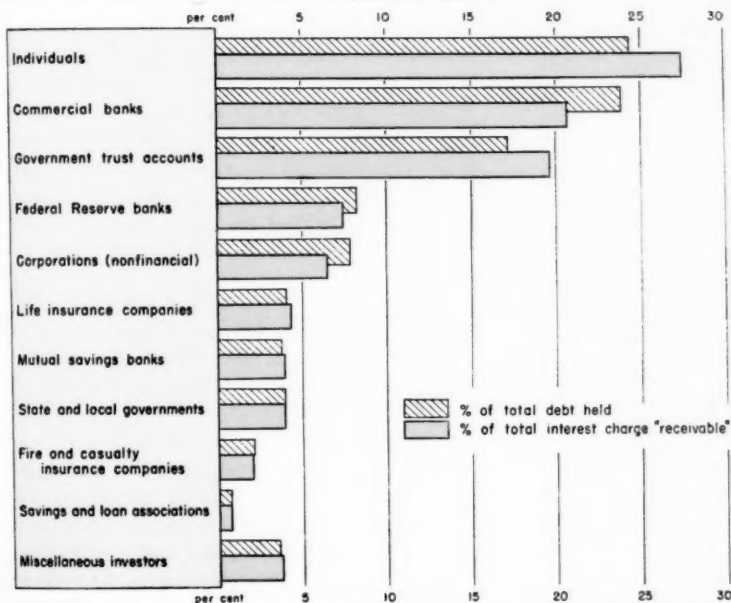
in terms of debt holdings and interest receivable, banks have slipped quite markedly from both their prewar and wartime positions.² For several years before the war and up through early 1946 (when the debt was at its peak), banks held the largest segment of the Federal debt. They also accounted for about 30 per cent of the interest charge. Since the end of the war, banks, along with insurance companies, have lost ground in the proportion of the total debt held.

The Government pays itself

Ranking very closely behind banks are the Government trust funds and investment accounts. These accounts are required by law to invest the bulk of their excess of receipts over expenditures in Government securities. As a result of their steady growth, they now

² For a more detailed discussion of the debt charge and its developments during the war years, see *Business Conditions*, July 1949, pp. 6-10.

Owners' earnings on the Federal debt



hold some 44 billion dollars of Federal securities—largely in the reserves of the social security accounts.

It has generally been the Treasury's practice, as a result of either legal requirements or of the earning needs of the various accounts, to issue to the trust funds special short-term securities not made available to the public. Currently 85 per cent of their investment is in these "special issues." Such securities, for the most part, bear an interest rate either equivalent to or higher than the average interest rate on the total debt. This is the only segment of the debt where 3½% and even 4% Government securities are still outstanding. Holdings of the trust funds are therefore the most expensive form of Federal debt and annual interest receivable by the funds (a noncash receipt) currently amounts to 1.2 billion dollars or almost 20 per cent of the total interest charge.

All told, over two-thirds of the entire Federal debt charge is payable to individuals,

commercial banks, and Government trust funds. The remaining third, some 2 billion dollars, provides a source of income for a variety of private businesses and institutions as well as for the Federal Reserve System and state and local governments. As indicated in the accompanying chart, interest shares ranging from less than 1 per cent to a little over 4 per cent go to savings and loan associations, mutual savings banks, insurance companies, and a miscellaneous group including nonprofit institutions, foreign investors,

¹ Annual interest charge estimated on the basis of coupon rates (or equivalent) on securities held June 30, 1952.

corporate pension trust funds, and brokers and dealers. For the greater part, the Government security holdings of most of these institutions are in longer term issues. As a result, the average rate of interest paid on the holdings of each of these groups is somewhat higher than the average rate on the total debt.

Lowest rate to corporations

In sharp contrast, the Governments held by nonfinancial business corporations carry the lowest average interest rate of any investor group—1.9 per cent. This reflects the developing practice for corporations to invest temporarily available funds in Treasury bills and other short-term Governments.

The 12 Federal Reserve Banks own about 23 billion dollars of Government securities, slightly more than half of which are Treasury bills and certificates. Their holdings carry an average interest rate only a shade above that for corporations and their share of total interest payable is a little over 7 per cent.

The Reserve banks, however, are essentially nonprofit institutions and their interest receipts arise as a by-product of their credit control operations. They return about 90 per cent of their net earnings to the Treasury in the form of quarterly interest payments on outstanding Federal Reserve notes not covered by gold certificates. And so, although approximately 400 million dollars of interest is payable to the banks on the basis of their current holdings, an estimated 300 million will be returned.

As a matter of fact, a sizable portion of Treasury interest payments to almost every recipient goes back to the Treasury via income taxes. Since 1941 the Treasury has issued exclusively securities on which the income is subject both to normal tax and surtax. Only 7.5 billion dollars of outstanding Governments, about 3 per cent of the total debt, are wholly, or as is generally the case, partially, tax exempt. Most of these securities are held by commercial banks.

The prime rate

After an uneven climb, it is up for debate again.

ONE OF THE MOST POPULAR TOPICS of conversation around the financial community in recent weeks has been the course of the so-called "prime rate". Both bankers and their major customers have been asking the questions, "Will it go up?" and, "If it goes up, can it stay?"

The prime rate—that charged by the nation's largest banks on short-term business loans to highest grade corporate borrowers—is generally regarded as one of the key elements in the private interest rate structure. It has been the traditional reflector of banker opinion as to the underlying level and trend of the "price of money".

At the present time, the prime rate stands at an even 3%. At this level, it is about 1.20 percentage points above the market yield on Treasury bills, 1.25 percentage points above Federal Reserve Bank discount rates, and about equal to the market yields on long-term high grade corporate bonds. But these relationships are not of long standing. In fact, the prime rate has outstripped all other money market rates in percentage points of increase over the postwar period.

Six postwar jumps

The prime rate climbed to its present level in six unevenly spaced steps. At the end of World War II, it stood at 1½%, a rate which had been maintained without variation since 1935. This level was held for two years longer in the face of beginning strong loan expansion and increases in Federal Reserve discount rates and yields on Treasury bills. At the peak of the seasonal loan rise in December 1947, however, the prime rate was raised to 1¾%. A second raise came eight months later. General

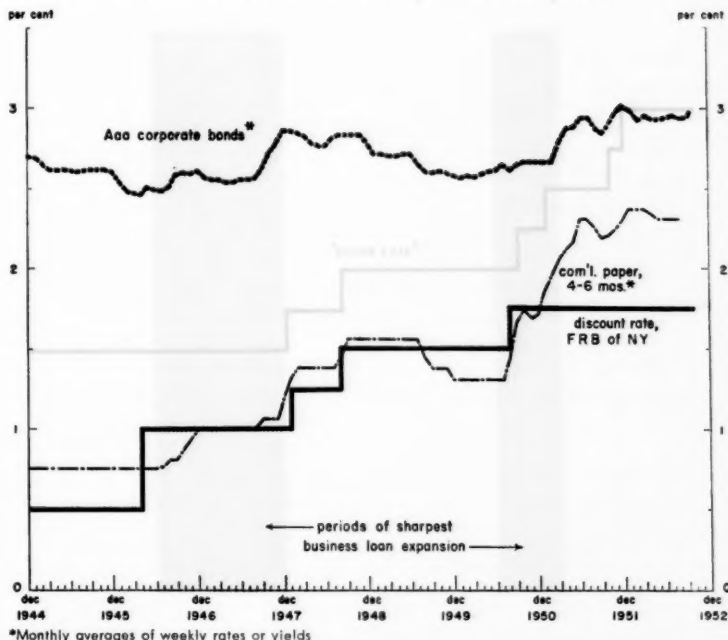
security market pressures and increases in the discount rate accompanied both these changes.

Through the 1949 recession and the first half of 1950, the prime rate was held at its 1948 level. With the eruption in Korea, however, a new and more rapid set of readjustments got under way. The first came in September 1950, a month after an increase in Federal Reserve discount rates and in an atmosphere of soaring loan demand and strong securities market pressures. Another increase followed in January 1951, and again in October. Finally, in December 1951, in the midst of unusual year-end money market tightness and false rumors of an impending rise in discount rates, the prime rate was moved up once more by the usual $\frac{1}{4}$ per cent amount. At $2\frac{1}{4}\%$ as 1951 had begun, it ended that year at an even 3% .

Rate patterns revised

In the course of these postwar movements, relationships between the prime rate and other market rates and yields have undergone changes. The most common comparison—partly because it is the simplest to make—is between the prime rate and the discount rate of the Federal Reserve Bank of New York. Because of the three 1951 increases, the prime rate is now 1.25 percentage points higher than the discount rate of $1\frac{3}{4}\%$. During the late Thirties and earlier postwar years, this margin was $\frac{1}{2}$ per cent. "Out of line" might be the

Postwar adjustments in market yields compared



hasty conclusion, yet judgment is not warranted without some consideration of basic changes in the general credit structure.

The late Thirties was a period of substantial surplus in loanable funds. During most of the Forties no such surplus existed, but another important influence did. The Government securities market, the arena in which residual supplies of and demands for funds typically are reconciled, was receiving substantial support from the monetary authorities. Since this support policy was changed in early 1951, a good part of the responsibility for resolving other than seasonal differences between credit demand and supply has reverted to the private financial structure. As a result, market yields and rates have become more flexible, with relationships shifting in response to private market pressure. In this environment the prime rate and the discount rate perform two different functions. The former is intended to reflect

demand and supply of bank *deposits* obtainable through short-term loans; the latter is a device helping to *affect* demand and supply of bank *reserves*. With such different purposes to be served, some deviations in level and degree of changes in these rates are to be expected.

From the point of view of rates on alternative sources of funds, the most eye-catching comparison is between the prime rate and market yields on high grade corporate bonds. After the war, indexes of triple-A corporate bond yields concentrated generally around 2½%, more than 1 percentage point above the announced prime rate. In ensuing years these indexes climbed only about ½ of a per cent, and most now are just equal to the prime rate. This does not mean new long-term financing is as cheap as short-term borrowing for corporations, since new bond issues are customarily floated at an attractive premium over the market for outstanding issues. Nonetheless, the closing of the gap is striking.

Here again, of course, a basic consideration is the renewed flexibility of the securities markets. Perhaps its most specific application is in terms of expectations of future flexibility, with market prices reflecting divergent attitudes concerning coming trends in short-term and long-term rates.

None of these relationships is unprecedented. Between 1920 and 1930, for example, the prime rate was often well above the discount rate and higher than many corporate bond yields as well. Few would characterize the Twenties as "normal", but those years do represent the most recent example of a period with a fairly high and flexible pattern of domestic market yields.

Determining the prime rate

In some respects, the above discussion gives a misleading impression of the character of the prime rate. It is not a statistic that is definitely ascertained through scientific reporting methods. By and large it is set by individual bank policy, with the information spread by

word of mouth and being publicly recorded chiefly in the press.

As an administered rate, there is no revelation of week-to-week fluctuations in the prime rate such as are common to its open market complement—market yields on short-term prime commercial paper. Nonetheless, from time to time loans to prime grade borrowers are made at rates different from the publicized "prime" level. Thus, despite the fact that the prime rate has been set at 3% since December 1951, some slackening in credit demand in the early part of 1952 led to the making of a number of loans to corporate customers at rates appreciably lower.

The changeability of market conditions and the negotiated nature of large loans make such occurrences inevitable. Competition for large loans among both bank and nonbank lenders is strong. Most corporations of any size have a choice of several alternative methods of obtaining funds, and in making that choice the borrowing cost is a consideration of consequence. A prime rate set too high—in relation to either the cost of borrowing nonbank money or the disadvantages of a firm's use of its own liquid assets—runs the risk of diverting some excellent corporate business.

The magnitude of credit at stake is far from negligible. Fragmentary information suggests that between one-third and one-half of the business loans made by the nation's largest banks is of sufficient quality to command a rate very close to the "prime" level. In addition, rates on most business credit of other than prime quality also move up and down with changes in the prime rate—although usually not as far.

Since all business loans, in turn, make up nearly 30 per cent of total earning assets of reporting banks, the volume of bank earnings sources subject to influence by the prime rate is very substantial. It is not surprising, therefore, that the "pros" and "cons" of any change in the prime rate are the subject of long and thoughtful banker consideration.

Home building *continued from page 4*

real estate credit on September 16 is in three parts. First, Regulation X, which imposed minimum cash down payments and maximum loan maturities on noninsured credit for new residential housing, was suspended. Lenders are now free to set their own minimum credit terms on conventional loans. Second, minimum down payment requirements on FHA insured loans were substantially relaxed on houses appraised at between \$8,000 and \$20,000, with the exception of the \$12,000 to \$13,000 range. The new limit of \$14,000 placed on FHA loans, however, results in higher down payments on houses priced above \$21,000 than had been required previously. Third, minimum down payments on VA guaranteed loans were greatly eased for houses valued above \$12,000, since only a nominal 5 per cent or less is now required for properties in all price ranges.

For conventional mortgages, the ending of controls probably will not bring any substantial easing of credit terms at this time. Institutional lenders are limited in their generosity by law, with statutory maximums on mortgage loans ranging from 60 per cent of appraisal value in the case of national banks to 80 per cent for Federally chartered savings and loan associations. Equally important, mortgage money is sufficiently scarce to limit the pressure of competition on lenders to relax terms. Therefore, most institutions probably will continue their present lending policies in an attempt to protect mortgage portfolios against possible future declines in market values.

In the case of VA loans, the difficulty lies in the limited availability of funds seeking investment at the relatively unattractive 4 per cent rate. Most institutional lenders have either placed restrictions on the amount of such loans which they will make or have gotten out of the market altogether. A sizable volume of VA mortgages is being purchased at discount from face value, but this practice is not likely to become general since builders must absorb

much of the discount paid. Thus, the return of a strong market for VA loans is dependent upon either an increase in the VA rate or a decline in interest rates generally.

The relaxation in FHA loan terms, on the other hand, seems likely to result in some stimulation of housing demand in the medium price range. Many lenders appear to be reasonably willing to invest loans at the 4¼ per cent rate and are likely to go along with the lower down payments.

What's ahead for next season?

Most builders interviewed in this area are proceeding cautiously regarding their building programs for next year. Many have experienced a buyer's market this summer for the first time in many years. Few believe that the ending of credit controls has had any direct effect on their sales potentials, but rather has only made possible a liberalization in credit terms which has not yet been forthcoming. Most builders are convinced that more credit on easier terms is the key to increased housing demand and higher levels of construction. Consequently, future plans are perhaps more tentative than usual for this time of year, but in general point to a maintenance of activity at about this year's level.

One thing is clear. Location, price, and workmanship are becoming increasingly important factors in selling new homes. Competition in the home-building industry is definitely on the upgrade.

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Postal Savings

LONG A CONTROVERSIAL INSTITUTION in financial circles, the Postal Savings System has been attracting considerable attention as a result of the prolonged decline in its deposits. The current 2.6 billion dollars in deposits and 3.4 million of depositors are 25 per cent below early 1948 peaks, although total savings have risen since that time.

The decline in Postal Savings has been nation-wide, with the sharpest drops recorded in most of the far western and southern states. Least affected has been the Middle West. With roughly 20 per cent of the country's population, the Seventh District states account for one-third of total postal deposits. Postal Savings have been most popular in those areas where branch banking is not practiced and where other private savings media have not been as readily available.

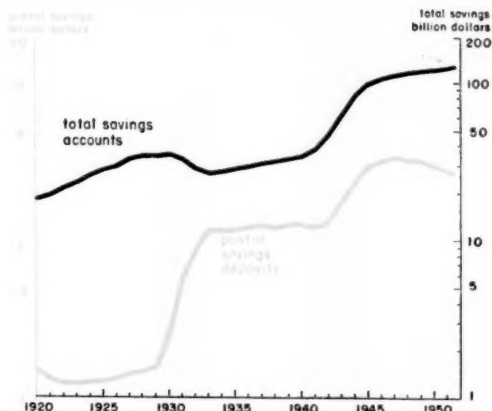
Although the Postal Savings System has been cited as a classic example of Government competition with private business, it has seldom been a very formidable competitor. Nor, compared with other savings institutions, has the Post Office Department ever made very aggressive efforts to attract new business to the program. In some periods Postal Savings deposits have grown faster than other forms of savings, but never have these deposits constituted over 5 per cent of total institutional savings.

In the 42 years of Postal Savings history, the program experienced three major booms—during World War I, the early 1930's, and World War II. The System's heyday came in the depression years. The closing of banks and the failure of savings and loan associations made the Government-backed Postal Savings System a haven for the funds of small savers. Since then, the establishment of the FDIC and the FSLIC has conferred to private savings institutions nearly the same assurance of safety and liquidity that the Postal Savings System always enjoyed. The fact that post offices are

widely dispersed is also losing significance. Ease of communication and the growth of savings departments and save-by-mail plans have expanded the availability of private savings facilities. Furthermore, the Postal System has never changed its flat 2% rate. At times that was a relatively high return. But in recent years, with many institutions raising the rates paid on savings, this has not been true.

Of all the contributing factors, however, the U.S. Savings Bond Program may account most significantly for the waning popularity of Postal Savings today. Through the Payroll Savings Plan, particularly, the small saver is given the advantages of Postal Savings—the chance to save regularly in small amounts, with complete liquidity, in a program maintained by the Government—plus the additional incentive of a higher rate of return. The Treasury, moreover, has conducted strong promotional campaigns in behalf of Savings Bonds. In a sense, therefore, the Postal Savings System has probably suffered more competition from the Government itself than it has from private savings institutions.

Postal Savings outpaced total savings growth in periods of national emergency



* Includes time deposits at all banks, savings and loan shares, savings banks and Postal Savings deposits